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PAGE 01 PARIS 03347 01 OF 05 030307Z
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EA-10 FRB-03 INR-07 IO-13 NEA-10 NSAE-00 USIA-06
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TAGS: OECD, ECON, UK
SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC): REVIEW OF THE UK ECONOMY

REF: EDR(78)2

1. SUMMARY: SECRETARIAT DRAFT SURVEY OF UK ECONOMY
IS BASICALLY A DESCRIPTIVE EFFORT UPDATING THE RATHER
EXTENSIVE SURVEY PUBLISHED LAST YEAR. SECRETARIAT NOTES
UK'S IMPLEMENTATION OF STABILIZATION POLICY AND SUCCESS
IN BRINGING DOWN RATE OF EARNINGS INCREASE, THUS MODERA-
TING INFLATION. KEY POINTS OF CONCERN FOR 1978 INCLUDE
RISK OF EARNINGS ACCELERATION IN PHASE III SETTING OFF
NEW INFLATIONARY SURGE AND POSSIBLE DETERIORATION OF
EXPORT COMPETITIVENESS WITH STRENGTH OF STERLING. MIS-
SION COMMENTS ARE NOTED IN PARA. 9. ACTION REQUESTED:
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PAGE 02 PARIS 03347 01 OF 05 030307Z

MISSION REQUESTS COMMENTS AND QUESTIONS FOR UK REVIEW.
WOULD APPRECIATE PARTICULAR ATTENTION BY ACTION ADDRESS-
EES TO ISSUES RAISED BY UK SURVEY SINCE U.S. IS ONE OF
TWO EXAMINING COUNTRIES FOR UK REVIEW (JAPAN IS THE
OTHER). REP FROM EMBASSY LONDON WILL PARTICIPATE IN
REVIEW ON FEBRUARY 13. END SUMMARY

2. RECENT TRENDS - DOMESTIC DEMAND: SECRETARIAT DESCRIBES DOMESTIC DEMAND IN 1977 AS WEAK IN ALMOST ALL COMPONENTS, ALTHOUGH SOME IMPROVEMENTS OCCURRED IN SECOND HALF. THE DECLINE IN PRIVATE CONSUMPTION (DOWN 1 PERCENT IN VOLUME) WAS DAMPENED BY A FALL IN THE SAVINGS RATIO WHICH NEVERTHELESS REMAINS HIGH (13 PERCENT) BY HISTORICAL STANDARDS. PRIVATE INVESTMENT WAS THE BRIGHTEST SPOT IN TERMS OF VOLUME INCREASE, BUT REMAINS EXTREMELY DEPRESSED AGAINST PRE-1970 TRENDS AND INCREASED IN 1977 WELL BELOW EXPECTATIONS (MANUFACTURING INVESTMENT: UP 5 TO 7 PERCENT; SERVICES AND DISTRIBUTION: STAGNANT; STOCKS: NET ZERO ON YEAR, I.E., INVOLUNTARY ACCUMULATION FIRST HALF, RUNDOWN IN SECOND). GOVERNMENT SPENDING WAS WELL BELOW EXPECTATIONS AS CASH LIMITS AND GENERAL FISCAL CAUTION RESULTED IN SUBSTANTIAL UNDERSPENDING -- PUBLIC INVESTMENT, CONTINUING A TREND OF RECENT YEARS, FELL 20 PERCENT WHILE PUBLIC CONSUMPTION WAS STAGNANT. TOTAL OUTPUT WAS VIRTUALLY UNCHANGED FROM 1976.

3. EMPLOYMENT, INCOMES AND PRICES: EMPLOYMENT INCREASED DURING 1977 DESPITE STAGNANT OUTPUT -- DUE PRINCIPALLY, ACCORDING TO SECRETARIAT, TO GOVERNMENT EMPLOYMENT PROGRAMS WHICH CREATED 250,000 NET NEW JOBS. WHILE SECRETARIAT BELIEVES TEMPORARY EMPLOYMENT SUBSIDY AND SMALL FIRMS EMPLOYMENT SCHEME WERE PRINCIPAL CREATORS OF JOBS LIMITED OFFICIAL USE

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PAGE 03 PARIS 03347 01 OF 05 030307Z

IN SHORT RUN, IT SUGGESTS TRAINING PROGRAMS WILL HAVE BENEFICIAL LONG-RANGE IMPACT. UNEMPLOYMENT, PRINCIPALLY AMONG LEAST SKILLED, FEMALES, YOUTHS, AND FREQUENT JOB SWITCHERS, REACTED TO SLOW FIRST HALF 1977 BY RISING TO 6 PERCENT IN LATE 1977. VOLUNTARY INCOMES POLICY (PHASES I, II) LED TO DECELERATION IN WAGE COSTS TO MID-1977 (8 PERCENT YEAR/YEAR TO JULY, 1977 VS. 13-1/2 PERCENT PREVIOUS TWELVE MONTH PERIOD) BUT FALL IN REAL EARNINGS LED TO RETURN TO "FREE COLLECTIVE BARGAINING" FOR PHASE III. NO CLEAR TREND YET ESTABLISHED, DUE TO UNUSUALLY SMALL NUMBER OF SETTLEMENTS, BUT SECRETARIAT JUDGES THAT CONCLUDED AGREEMENTS ARE GENERALLY ABOVE THE GOVERNMENT'S TEN PERCENT EARNINGS INCREASE TARGET. INFLATION ALSO DECELERATED PRINCIPALLY DUE, IN OPINION OF SECRETARIAT, TO SLOWDOWN IN AVERAGE EARNINGS. SECRETARIAT DOES NOT BELIEVE NEW SELECTIVE APPROACH OF PRICE COMMISSION WILL HAVE SIGNIFICANT IMPACT ON PRICE TRENDS WHICH IT EXPECTS TO BE RESTRAINED BY CONTINUING UNUTILIZED CAPACITY AND WEAK DEMAND.

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PAGE 01 PARIS 03347 02 OF 05 030315Z

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4. EXTERNAL SECTOR: THE FORTUNES OF STERLING ARE CITED AS INDICATION OF THE REMARKABLE CHANGES IN THE UK EXTERNAL SECTOR DURING 1977. RESERVES WERE BOLSTERED BY LARGE "ACCOMMODATING" TRANSACTIONS (IMF AND OTHER OFFICIAL BORROWING, ONE-TIME INFLOW DUE RESTRICTIONS ON STERLING FINANCING OF THIRD COUNTRY TRADE) AND MORE AUTONOMOUS CAPITAL INFLOWS BOTH OF SPECULATION NATURE (STEMMING FROM DOLLAR WEAKNESS) AND DUE TO RENEWED CONFIDENCE IN UK ECONOMIC POLICIES. CURRENT ACCOUNT ALSO SWUNG MORE SHARPLY TO SURPLUS THAN EXPECTED AS SERVICES SURPLUS STRENGTHENED, OIL DEFICIT SHRANK SHARPLY, AND NON-OIL TRADE MOVED UNEXPECTEDLY TO LARGE SURPLUS. LATTER WAS DUE TO VIRTUALLY UNPRECEDENTED GROWTH OF BRITISH EXPORT MARKET SHARES (EXPORTS EXPANDED 2 PERCENT FASTER THAN MARKET GROWTH FROM MID-1976 TO MID-1977), PARTIALLY REFLECTING LAGS TO PRICE ADVANTAGES GAINED DURING 1976 STERLING PLUNGE. WEAK DOMESTIC DEMAND ALSO A POSSIBLE FACTOR AS FIRMS REORIENTED EFFORTS TO EXPORT MARKETS.

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PAGE 02 PARIS 03347 02 OF 05 030315Z

DESPITE WEAK OVERALL DOMESTIC DEMAND, IMPORTS SURGED, AND THE IMPORT SHARE OF GDP INCREASED 5 PERCENTAGE POINTS DURING TWO YEARS 1976-77. SECRETARIAT ATTRIBUTES THIS BEHAVIOR PARTIALLY TO SHIFTS IN TASTES TO IMPORTED GOODS, BUT PRINCIPALLY TO NON-PRICE FACTORS RESULTING FROM LOW INVESTMENT EFFORTS IN RECENT YEARS.

5. ECONOMIC POLICY - FISCAL: SECRETARIAT CHARACTERIZES 1977 UK FISCAL POLICY STANCE AS RESTRICTIVE IN DESIGN AND EVEN MORE RESTRICTIVE IN RESULT. NET RESULT OF MIX OF EXPENDITURE CUTS AND NET TAX REDUCTIONS (LATTER WERE, ACCORDING TO SECRETARIAT, NOT SUBSTANTIALLY AFFECTED BY TERMINATION OF FORMAL VOLUNTARY INCOMES POLICY) PLUS SUBSTANTIAL UNDERSPENDING LED TO PSBR IN 1977 EQUAL TO 3-1/2 PERCENT GDP, VICE EXPECTED 6 PERCENT IN 1977 AND ACTUAL 7 PERCENT IN 1976. REDUCTION IN OVERALL GOVERNMENT DEFICIT WAS EVEN MORE RESTRICTIVE THAN INDICATED BY ABOVE RATIOS SINCE REAL ECONOMY HAD MORE SLACK IN 1977 THAN 1976. SECRETARIAT ATTRIBUTED BULK OF UNDERSPENDING TO INSTITUTIONAL FACTORS (CASH LIMITS) AND GENERAL PSYCHOLOGY SURROUNDING THE BINDING PLEDGE TO IMF ON PSBR AND DCE.

6. MONETARY: IN ITS SECOND YEAR OF TARGETING MONETARY AGGREGATES, THE MONETARY AUTHORITIES CONFRONTED A SITUATION VIRTUALLY THE REVERSE OF THE FIRST YEAR. FOREIGN BUYERS WERE ANXIOUS TO OBTAIN STERLING ASSETS, AND DEMAND FOR GILT SECURITIES WAS GENERALLY GREATER THAN THE INTENDED SUPPLY. THUS, EARLY IN 1977 HEAVY DOWNWARD PRESSURE WAS EXERTED ON THE INTEREST RATE (BOTH LONG THROUGH GILTS AND SHORT THROUGH SHORTAGE OF BILLS AS RESULT POLICY OF USING EXCESS FUNDS FROM GILTS TO REDEEM BILLS) -- WHILE, ACCORDING TO THE SECRETARIAT, LIMITED OFFICIAL USE

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PAGE 03 PARIS 03347 02 OF 05 030315Z

M3 WAS LOWER IN MARCH, 1977 THAN NOVEMBER, 1976. SECRETARIAT CHARACTERIZES THIS SITUATION "AS AN EASING" IN MONETARY CONDITIONS. THROUGHOUT YEAR, MONETARY AUTHORITIES WERE, ACCORDING TO SECRETARIAT, DOING A BALANCING ACT BETWEEN KEEPING POUND FROM APPRECIATING AND ENFORCING THE M3 TARGET -- EMPLOYING A NUMBER OF POLICY AND INSTITUTIONAL INNOVATIONS BUT, ULTIMATELY ALLOWING STERLING TO RISE IN THE INTEREST OF MAINTAINING CREDIBILITY IN THE GOVERNMENT'S COMMITMENT TO STABILIZATION POLICY, INCLUDING THE M3 TARGET.

7. SECRETARIAT'S FORECASTS: OUTCOME IN 1977 BASICALLY IN LINE WITH SECRETARIAT FORECAST IN LAST YEAR'S SURVEY (MARCH, 1977), WITH EXCEPTIONS THAT PRIVATE CONSUMPTION STRONGER (DUE TAX CUTS), INVESTMENT WEAKER (DUE GOVERN-

MENT UNDERSPENDING) AND OUTPUT WEAKER (DUE HIGHER IMPORTS)

-- FIRST TWO DISCREPANCIES CAUSED BY "NO-POLICY-CHANGE"
ASSUMPTION. FOR 1978, SECRETARIAT FORECASTS:

-- FISCAL POLICY: GOVERNMENT SPENDING, PER WHITE PAPER:
UP 8-1/4 PERCENT, WITH GOVERNMENT CONSUMPTION UP ONLY 2
PERCENT, PUBLIC INVESTMENT STAGNANT, FINANCIAL OPERATIONS
AND TRANSFERS ABSORB REMAINDER OF SPENDING INCREASE.
WITH LARGE INCREASE IN TAX RECEIPTS (ON BASIS CURRENT
TAX RATES AND GIVEN ACCELERATION IN EARNINGS), BUDGET
DEFICIT AND PSBR MAY SHOW SLIGHT FURTHER REDUCTION IN
RELATION TO GDP IN 1978.

-- PRIVATE CONSUMPTION: UP 3-3/4 PERCENT IN FIRST HALF,
SLOWING TO 2-1/2 PERCENT IN SECOND ON ASSUMPTION OF 14
PERCENT RISE IN NOMINAL EARNINGS, BUNCHED IN FIRST HALF.

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PAGE 01 PARIS 03347 03 OF 05 030309Z
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TO SECSTATE WASHDC 5237
AMEMBASSY LONDON
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-- PRIVATE INVESTMENT: GENERALLY BUOYANT, UP 12 PERCENT
IN MANUFACTURING (5-1/4 PERCENT DURING THE YEAR), SER-
VICES AND DISTRIBUTION AND RESIDENTIAL BOTH UP BUT LESS
THAN MANUFACTURING, AND STOCKS CONTRIBUTING MODERATE
PLUS.

-- TOTAL DOMESTIC DEMAND: UP 3-1/4 PERCENT OVERALL;
STRONG FIRST HALF (UP 6 PERCENT) SLOWING IN SECOND
(2-1/2 PERCENT).

-- EXTERNAL SECTOR: SMALL NEGATIVE REAL EFFECT AS NON-
OIL EXPORTS LOSE MARKET SHARES SLIGHTLY AND IMPORTS
CLIMB IN RESPONSE TO DOMESTIC DEMAND RECOVERY. ON CUR-
RENT ACCOUNT, HOWEVER, FORECAST SHOWS \$3 BILLION SURPLUS
AS TERMS OF TRADE IMPROVE.

-- GDP: UP 3-1/4 PERCENT OVERALL, WITH SHARP DECELERA-
TION TO 1-1/2 PERCENT IN SECOND HALF.
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PAGE 02 PARIS 03347 03 OF 05 030309Z

-- EMPLOYMENT: LABOR FORCE UP 1/2 PERCENT (STRONG POSI-
TIVE INFLUENCE OF DEMOGRAPHIC FACTORS WHILE FEMALE PAR-
TICIPATION RATES SLOW DOWN), SLIGHT FALL IN TOTAL EMPLOY-
MENT IN 1978 FIRST HALF RECOVERING IN SECOND; YEAREND
UNEMPLOYMENT SLIGHTLY ABOVE 6 PERCENT.

-- PRICES: BASED ON 14 PERCENT EARNINGS INCREASE, INFLA-
TION (CPI) SHOULD BE IN SINGLE FIGURES FOR YEAR, WITH
ACCELERATION IN SECOND HALF AS IMPACT OF EARNINGS BEGINS
TO OVERCOME DAMPENING EFFECTS OF STERLING APPRECIATION.
RISE IN GDP DEFLATOR HIGHER THAN CPI OVER YEAR, REFLECT-
ING DOMESTIC COSTS MORE ACCURATELY.

8. SECRETARIAT CONCLUSIONS: DRAFT SURVEY RECOMMENDS
FOLLOWING MAIN CONCLUSIONS:

-- BALANCE OF PAYMENTS CONSTRAINT GREATLY REDUCED, BUT
INFLATION CONSTRAINT CALLS FOR CONTINUED PRUDENCE IN
DEMAND MANAGEMENT.

-- MODERATE UPTURN IN ACTIVITY IS DESIRABLE IN ORDER TO:

- ALLEVIATE HIGH UNEMPLOYMENT
- RAISE PROFIT LEVELS, THUS STIMULATING INVESTMENT
- KEEP EXTERNAL SURPLUS WITHIN "REASONABLE LIMITS"
IN KEEPING RELATION TO WHAT IS INTERNATIONALLY
DESIRABLE
- RELIEVE UPWARD PRESSURE ON STERLING, THUS AIDING
COMPETITIVE POSITION OF UK MANUFACTURED EXPORTS,
REVERSING "SLOW PROCESS OF DE-INDUSTRIALIZATION"
OF THE ECONOMY.

-- PAY POLICY MUST SEEK TO RESTRICT NOMINAL EARNINGS
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PAGE 03 PARIS 03347 03 OF 05 030309Z

INCREASES TO ACHIEVE LOWEST POSSIBLE INCREASE IN PRICES;
FOCUS SHOULD BE ON REAL EARNINGS WITH TAX CONCESSIONS
CONDITIONAL ON MODERATION.

-- MONETARY POLICY SHOULD BE MADE MORE FLEXIBLE (NOT
NECESSARILY LESS RESTRICTIVE) THROUGH SHORTER TARGET
PERIOD (E.G., 6 MONTHS, OR ROLLOVER) AND LESS EMPHASIS
ON SINGLE MONTHLY AGGREGATE BEHAVIOR (VIA MOVING AVER-
AGES, E.G.).

9. MISSION COMMENTS:

(A) COMMENTARY IN BRITAIN AS WELL AS THE RECENT IMF
REPORT ON THE STANDBY AGREEMENT DESCRIBE 1977 UK ECO-
NOMIC PERFORMANCE IN TERMS OF SUBSTANTIAL IMPROVEMENT
ON THE FINANCIAL SIDE WITH STAGNATION OR PERHAPS DECLINE
ON THE REAL SIDE. THE RECENT CBI INDUSTRIAL SURVEY SEEMS
TO SUGGEST THAT THE FINANCIAL IMPROVEMENT HAS IN SOME
WAYS HARMED RECOVERY ON THE REAL SIDE THROUGH DETERI-
ORATING PRICE CONDITIONS FOR BRITISH EXPORTS. SECRE-
TARIAT SURVEY DOES NOT REALLY ADDRESS THIS QUESTION AND
WE PROPOSE TO EXPLORE IT WITH THE UK DELEGATION.

(B) ALTHOUGH STATING THAT NO REAL TREND HAS AS YET BEEN
ESTABLISHED IN PHASE III, THE SECRETARIAT ASSUMES FOR
FORECAST PURPOSES A 14 PERCENT INCREASE IN EARNINGS.
GIVEN POSSIBLE PSYCHOLOGICAL IMPACT OF SUCH A FIGURE

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PAGE 01 PARIS 03347 04 OF 05 030316Z

ACTION EUR-12

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LIMITED OFFICIAL USE SECTION 04 OF 05 PARIS 03347

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IN THE PUBLISHED SURVEY WHICH WOULD BE RELEASED IN THE MIDDLE OF THE WAGE ROUND, MISSION PLANS TO EXPLORE BASIS OF ASSUMPTION WITH SECRETARIAT AND DETERMINE WHETHER IT IS CONSISTENT WITH SECRETARIAT'S OWN ADMONITION THAT NOMINAL INCREASES SHOULD BE MINIMIZED.

(C) SECRETARIAT NOTES THAT UPWARD PRESSURE ON STERLING MAY HAVE SIGNIFICANT NEGATIVE IMPACT ON UK EXPORTS FOR 1978 AND ABILITY OF UK ECONOMY TO STIMULATE INVESTMENT IN EXPORT SECTOR. MISSION PLANS TO RAISE POSSIBLE ROLE OF LIBERALIZATION OF CAPITAL EXPORTS AS MEANS OF PARTIALLY RELIEVING UPWARD PRESSURE ON STERLING (WHILE MAKING RATE MORE REALISTIC).

(D) ALTHOUGH POLITICALLY SENSITIVE, THE ONGOING DEBATE ON THE USE OF NORTH SEA OIL REVENUES (BOTH AS INCOME TO GOVERNMENT AND AS BALANCE OF PAYMENTS RECEIPTS) BEARS DIRECTLY ON UK'S MEDIUM-TERM ECONOMIC OUTLOOK. GIVEN SENSITIVITY OF SUBJECT AND FACT THAT ESSENTIAL ISSUES
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PAGE 02 PARIS 03347 04 OF 05 030316Z

AND ALTERNATIVES WERE REVIEWED IN 1977 SURVEY, MISSION WOULD NOT PROPOSE THAT THIS SUBJECT BE TREATED IN ANY DEPTH IN 1978 SURVEY. HOWEVER, MISSION BELIEVES IT WOULD BE APPROPRIATE TO ENGAGE UK DELEGATES IN DISCUSSION ON STATUS OF THE DEBATE, IN COURSE OF EDRC EXAMINATION.

(E) SECRETARIAT NOTES THE SUBSTANTIAL IMPORT PENETRATION IN THE UK 1976-77 WITHOUT DOING PARTICULARLY RIGOROUS ANALYSIS OF CAUSES. WE WOULD PLAN TO ASK UK DELEGATION TO EXPLAIN THIS PHENOMENA.

(F) THE LOW LEVEL OF INVESTMENT IN THE PRIVATE SECTOR IN THE PAST FEW YEARS, AS WELL AS THE RECENT UNDERSPENDING OF PUBLIC INVESTMENT FUNDS, MAY HAVE CREATED A SITUATION IN WHICH A NUMBER OF INVESTMENT PROJECTS HAVE BEEN DEVELOPED BUT ARE WAITING FOR IMPROVED ECONOMIC CONDITIONS TO BE IMPLEMENTED. MISSION PLANS TO ASK UK DELEGATION WHETHER THIS HYPOTHESIS REASONABLE AND, IF SO, WHETHER FASTER THAN NORMAL ACCELERATION OF INVESTMENT MIGHT BE EXPECTED WHEN CONFIDENCE RETURNS TO THE PRIVATE

SECTOR.

(G) IN PAST EXAMINATIONS, WHILE MISSION HAS SUPPORTED REDUCING OVERALL SIZE OF UK'S PUBLIC SECTOR, WE HAVE QUESTIONED DESIRABILITY OF SHARP TREND REDUCTION IN PUBLIC INVESTMENT. WE BELIEVE THAT THIS IS STILL AN APPROPRIATE QUESTION.

(H) SECRETARIAT EMPHASIZES THE NECESSITY FOR MAKING TAX CUTS CONDITIONAL ON RESTRAINT IN WAGE SETTLEMENTS. MISSION PLANS TO ASK UK DELEGATION AND SECRETARIAT WHETHER THERE IS EVIDENCE THAT TAX CONCESSIONS, AS OPPOSED TO LIMITED OFFICIAL USE

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PAGE 03 PARIS 03347 04 OF 05 030316Z

SLACK LABOR MARKET CONDITIONS AND LABOR GOVERNMENT, WERE PRINCIPAL DETERMINANTS OF WAGE MODERATION UNDER PHASES I AND II.

(I) IN AN ANNEX TO THE MAIN SURVEY, THE SECRETARIAT CATALOGUES OPERATIONAL EMPLOYMENT SCHEMES IN THE UK. THIS CATALOGUE DOES NOT ATTEMPT TO ANALYZE THE IMPACT OF THESE SCHEMES ON FACILITATING (OR HINDERING) STRUCTURAL ADJUSTMENT. MISSION BELIEVES IT WOULD BE USEFUL TO DISCUSS THIS ASPECT WITH UK DELEGATION.

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PAGE 01 PARIS 03347 05 OF 05 030308Z
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LIMITED OFFICIAL USE SECTION 05 OF 05 PARIS 03347

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(J) MISSION AGREES WITH SECRETARIAT'S PRUDENT PRESCRIPTION FOR MONETARY POLICY STANCE WHICH CALLS FOR MAINTAINING FLEXIBILITY IN RESPONDING TO REQUIREMENTS OF CONFLICTING OBJECTIVES (REDUCING INFLATION, RECOVERY OF ACTIVITY, AVOIDING UPWARD PRESSURE ON EXCHANGE RATE). NEED TO RESPOND TO DANGER IN SITUATION MAY WELL ARGUE FOR SOME CHANGE IN TECHNIQUE OF MONETARY TARGETING. WE ARE, HOWEVER, INCLINED TO FEEL THAT SECRETARIAT IS EXCESSIVELY WEDDED TO ITS SUGGESTION OF SEMI-ANNUAL "ROLL-OVER" TARGETS. MISSION WOULD PROPOSE TO ASK FOR UK DELEGATION'S REACTION.

10. GENERAL COMMENT: REFDOK IS NOT UP TO SECRETARIAT'S NORMAL HIGH QUALITY, PARTICULARLY FOR AN ECONOMY AS IMPORTANT AS THE UK. IT IS PERFUNCTORY, DESCRIPTIVE (VS. ANALYTICAL) AND IN GENERAL LOOSE. MISSION PLANS TO EXPRESS ITS DISSATISFACTION WITH THIS DRAFT SURVEY TO THE SECRETARIAT, WHILE RECOGNIZING THAT MAJOR STRUCTURAL LIMITED OFFICIAL USE

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PAGE 02 PARIS 03347 05 OF 05 030308Z

MODIFICATION NOT FEASIBLE. WE ATTRIBUTE THE WEAKNESS OF THIS SURVEY TO THE FACT THAT THERE HAS BEEN A SHIFT IN THE SECRETARIAT'S STAFF HANDLING UK AFFAIRS. IN FACT, DRAFT SURVEY WAS MAINLY WRITTEN -- EVIDENTLY IN HASTE -- BY A FORMER MEMBER OF THE SECRETARIAT WHO WAS ASKED TO RETURN FOR THE MONTH OF DECEMBER TO PREPARE THE DOCUMENT.

11. ACTION REQUESTED: SINCE U.S. IS EXAMINING COUNTRY FOR UK REVIEW, MISSION WOULD PARTICULARLY APPRECIATE CAREFUL ATTENTION TO ISSUES RAISED BY UK SURVEY, AND SUGGESTIONS FOR ADDITIONAL QUESTIONS/COMMENTS TO BE USED DURING THE FEBRUARY 13 REVIEW. REP FROM EMBASSY LONDON WILL PARTICIPATE IN REVIEW.
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